



Tax Impacts of Hurricane Ivan

By *L. Louis Hyman*, Fire Staff, Alabama Forestry Commission

Hurricane Ivan visited Alabama on September 16, 2004. The Hurricane smashed Gulf Shores in the early morning, then proceeded northeasterly across the state, devastating the forests of southwest Alabama. Tree and home damage occurred across the state before the storm exited into Tennessee late that evening. Even when the hurricane winds began to lessen, imbedded thunderstorms produced straight-line downbursts that knocked over trees and snapped power lines across the state.

The storm had a tremendous impact on our state, with effects that will last for several years. There is some help available to homeowners and landowners within the casualty loss regulations of the Federal Income Tax Codes. These rules apply to all casualties, which is damage caused by any windstorm, fire, ice, or theft.

In order to be considered a casualty loss, the damage must occur because of an identifiable event that is “sudden, unexpected, or unusual.” Hurricane Ivan fits this definition, and its damages can be considered casualty losses. In this article,

we will look at how to handle casualty loss damage to homes, yard trees, forest improvements, and standing timber. We will also look at how to handle the loss and things you can do now.

Damage to Homes

The basic rule for calculating a casualty loss is to determine the decrease in the Fair Market Value (FMV) of the property from just before and just after the casualty event, minus any insurance payments received. The loss is limited to the adjusted “basis” in the property.

For a home, the change in FMV can be done by either getting a formal appraisal of the house after the storm, or by totaling the cost of cleanup and repairs. You can use the cost of repairs as an estimate of the change in FMV if the repairs are actually done; if they are needed to return the property to pre-storm condition, but not increase the value of the property; if the repairs are for damage only; and if the costs are not excessive.

You cannot use cost of repairs if the work increases the value of the property. You can use the cost of repairing a wood shingled exterior wall, but you cannot

include the cost of adding a new brick veneer siding.

The actual loss is the cost of repairs, minus any insurance payments received. For most folks, this means the casualty loss will be the insurance deductible, plus any loss that insurance will not cover, such as damage to furnishings from rain, leaking, or flooding.

In addition, the IRS limits losses to the adjusted basis of the property, which includes depreciation of furnishings and equipment. If the house is a total loss, then the casualty loss will be the adjusted basis of house and furnishings less any insurance received. The IRS also has deduction limits, which are outlined below.

Damage to Yard Trees

The same general rule applies to shade trees and yard landscaping. The loss is the change in FMV of the property, less any insurance. This can be estimated by the cost of removing any damaged or destroyed trees and shrubs, less any salvage income (from firewood sales), and the cost of replanting or pruning. Again this is limited to the basis of the property.

For very large shade trees or very special specimen trees, an appraisal of the property may show a larger change in the FMV of the property with the loss of the tree. There are certified arborists who can do this special appraisal. Again, the loss is limited to the basis of the entire property.

Damage to Forest Improvements

Part of the impact from the hurricane was damage or destruction of forestland improvements such as roads, bridges, fences, gates, and shooting houses. Similar to home damage, the loss is the change in FMV of the property, or it can be based on the cost of clearing and repairs, limited by the basis in the land. These costs must be reasonable and necessary to restore the property to its condition prior to the storm. Any insurance payments should be deducted from the cost to get the loss.

Damage to Standing Timber

Again the theory is that the casualty loss is the change in FMV, less any reimbursement, limited to the basis. A deduction is allowed only if the damage renders the timber unfit for use, or results in it being sold for less value than it was appraised for prior to the storm.

The landowner must attempt to salvage the damaged timber, even though it results in saw timber trees being sold as pulpwood, with depressed stumpage prices. If no buyers are willing to purchase the trees, the landowner needs to document contacts made and their refusal to purchase.

The timber loss is the change in value from what it was appraised prior to the storm, to its salvage value, or zero if it cannot be salvaged. The big limit on this is the BASIS of the timber. For most persons, the basis is very small, either because the stand was natural regeneration, or the basis was used up by the reforestation tax credit and amortization, or by the fact that the land was purchased many years ago.

Let's look at an example. John owns 40 acres of forestland, with 200 MBF (thousand board feet) of saw timber, with a pre-storm value of about \$50,000. His adjusted timber basis was \$2,000. The hurricane knocked it all down. If he could not salvage the timber, his casualty loss would be \$50,000 or \$2,000 basis, whichever is smaller. If he could sell his wood for pulpwood salvage, he might get \$3,000. In that case, the casualty loss would be \$50,000 less \$3,000 equals \$47,000, or \$2,000 basis. In either case, the loss would be limited to the basis in the timber or \$2,000.



Photo by Elishia Johnson

Involuntary Conversion Income

In the example above, the landowner was able to salvage his timber, and the income he received would be considered involuntary conversion income. What this means is that the timber was sold against his wishes; he had to sell because of the hurricane damage.

In a recent court ruling (*Weyerhaeuser Company vs. the United States*), the court ruled that a landowner should treat the

casualty loss and the later salvage as two separate events. First, the landowner calculates the casualty loss using either the change in FMV or the basis. He then books this as a loss deduction against ordinary income. This deduction uses up all the basis in timber on the tract. Secondly, he sells the salvage timber. This sale income is netted against any remaining timber basis (in most cases – zero) and an involuntary conversion gain is incurred. This gain can be deferred (see next section) or treated as capital gains income.

Deferring Involuntary Conversion Income

Under a Revenue Ruling issued in 1980, known as the Hurricane Frederick Rule, if a landowner has Involuntary Conversion gains, and uses that income to buy replacement property, the “gain” is deferred until the new timber is cut. This ruling was codified as IRC Section 1033.

What this means is that when a landowner has a severe casualty loss and salvages his timber, the landowner can re-invest in trees and not pay taxes until the trees are later sold. The re-investment can be either the purchase of new forestland with standing trees, or reforestation (site preparation and replanting) of the damaged timber stand.

There is a two-year replacement period for this benefit. If the trees are salvaged in 2004, you have until January 1, 2007 (or January 1, 2008 if salvaged in 2005) to replace the timber. The new stand will receive the basis of the original stand (which will

be \$0) so that when you sell the timber years from now, you will pay capital gains tax on the entire sale income. If you do not spend all the salvage income for timber replacement, you must pay capital gains tax on the difference. If you spend more than the salvage income, the rest of the cost, above the salvage income, is put into the new basis for the stand.

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Reporting Casualty Losses

Casualty losses are reported using IRS Form 4684 and on personal tax Form 1040. Generally, the casualty loss is reported in the tax year in which the casualty occurred. Any salvage income is either reported in the year in which it is received, which may be the next year, or a statement of deferral of casualty income is made. If you choose to defer taxes on casualty income, you must attach a written statement to your tax form for that year. The statement must list the date and details of the casualty, the income you received, and your intention to use that income to purchase replacement property under Section 1033.

The IRS separates tax treatment of casualty losses on "personal use" property from business or investment properties. Personal use property includes homes, real estate, and personal items that are not purchased as an investment or used in a business. Casualty losses on personal use properties must first be reduced by \$100 per event, then further reduced by 10 percent of the taxpayer's adjusted gross income.

For example, your home was flooded with \$10,000 damage that your insurance would not cover, and your family's adjusted gross income was \$70,000. Your loss would be \$10,000 less \$100, less 10% of \$70,000, for a deductible loss of \$2,900.

If the property is within a Federally Declared Disaster Area, which for Hurricane Ivan includes the entire state of Alabama, you can choose to deduct your

casualty loss on an amended tax return for the previous year. Usually this results in lowered income for that year, and an additional tax refund. The taxpayer can otherwise choose to claim the loss in the year of the casualty, and wait until the next spring to get a possible refund. The advantage of filing an amended return is that the refund may come faster than waiting until next April.

For a disaster occurring in 2004, you have until April 15, 2005 to claim a casualty loss on an amended return for tax year 2003.

What Do I Do Now

Wow, this is a lot of information in a very short space. What should you as a landowner with hurricane damage do first? There are some simple steps each of us can take. Make up a Hurricane Ivan folder. First, document the loss. Take pictures, collect newspaper clippings, and print out web pages that show the hurricane and what it did to your property and area.

Second, collect financial records and advice. Figure the basis in your house, property, and timber. Save copies of insurance checks, salvage income, and repair costs. (Also, make a copy of this article and put it into the file for later reference.)

Third, salvage what you can, and repair what you can. Get the best price possible for salvage, which will be significantly lower than prices were last summer. Work with your logger and keep records. If you sell by the ton, make sure

to get copies of the trip tickets, to document the volume removed. Also make sure the number of truckloads leaving your property equals the number of trip tickets you receive. There will be an increased amount of timber harvesting over the next year, and loggers and mills might get confused as to which load came from which landowner.

Fourth, get with a Certified Public Accountant (CPA) early. Have your CPA determine if an amended 2003 return claiming the casualty loss would work for you. Share this article to help the CPA plan what is best for you. Spring will be real busy for CPAs with so many other landowners in the same boat, but your accountant may have time to help you now.

Hurricanes, storms, and fires are facts of life in forestland management. Your TREASURE will survive. 🌲

WHAT IS BASIS?

This article uses the phrase "adjusted basis" several times. What does this mean?

Basis is the cost of the property, when you acquired it. You acquire basis in three ways: You can buy the property, you can inherit the property, or you can build the property, including planting trees.

When you buy a property, the cost is allocated to the different parts of the property, such as the land, any houses or structures, and the timber. A buyer would allocate part of the purchase price to each area and record that value.

When you inherit a property, the basis is the fair market value of the property, and all the parts, on either the date of death or when the estate is probated (within nine months of death). This stepped-up basis is the only time the value of the property is used instead of the cost of acquisition.

The third way to get basis is to build something. When you build a house on a lot, you create basis in that structure. Similarly, when you plant trees on your land, the new trees have a basis, which is the cost of reforestation.

Basis is adjusted over time by either adding more to it by building new things, or by selling off parts of the property, such as a timber thinning. 🌲

Photo by Elishia Johnson

